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Japan

The non-performing country

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If Japan does not write off its bad loans, will the world write off Japan?

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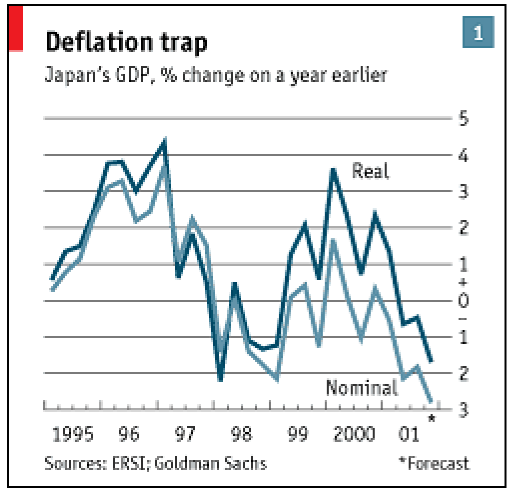
WHEN George Bush and Junichiro Koizumi met in Washington last June, it was the American president who seemed the more politically insecure and the Japanese prime minister who was riding high. Now, as they prepare to meet in Tokyo next week, their positions seem to be reversed. Mr Bush looks more sure-footed than he did last summer, and he has the kind of sky-high public approval once enjoyed by his Japanese counterpart. Mr Koizumi's fall from grace, meanwhile, has been swift and stunning. Since he sacked his popular foreign minister last month, his poll numbers have plunged. Worse, Mr Koizumi's plight may make him more helpless than ever against Japan's triple menace of debt, deflation and political deadlock.

When Mr Bush comes to visit, all eyes will be on Japan's economic slide

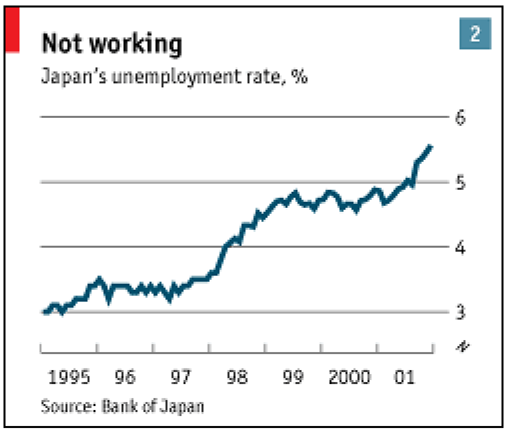
That is why Mr Bush's anti-terrorism campaign will not seem the most pressing issue when he arrives on February 17th, starting a week-long tour of Japan, South Korea and China. Of course, Mr Bush will want to discuss the regime in North Korea, which he has recently fingered as a member of his "axis of evil". He will also praise Japan for sending support ships to the Indian Ocean to help America in the Afghanistan campaign. But all eyes next week will be on Japan's economic slide, and on Mr Koizumi's newest set of promises—to be unveiled for Mr Bush's benefit—that he will do something about it.

Those glancing in from a distance may find it hard to tell Japan's current mess from the general doom and gloom of the past decade. But people watching more closely see three especially strong reasons to tremble now. The first is that deflation and depressed spending continue unabated, bringing fears of an accelerating downward spiral. Consumer prices have fallen every month for more than two years. Retail sales have fallen for more than three years, and were down by nearly 6% in the year to December. GDP is once again falling in real terms; nominal GDP is falling even faster (see chart 1).

Only a few months ago many Japanese economists were still saying that Japan's deflation might be healthy, since lower prices make life better for consumers. Those optimists have gone silent, however, as falling prices have continued to be matched by dwindling jobs. Japan's unemployment rate rose to 5.6% in December, the highest since the second world war and nearly a percentage point above the rate a year ago (see chart 2). More than a million heads of Japanese households are now out of work.



The job losses follow collapsing balance sheets at weak Japanese companies, as falling prices squeeze profits and make it harder for them to service their debts. More than 19,000 companies went bankrupt last year, many of them small and mid-sized suppliers feeding Japan's bigger conglomerates.



Worse, the job cuts keep accumulating. Successive waves of lay-offs eat further into national income and confidence, hampering household spending and sending slightly healthier firms to the wall. Last year, such well-known corporate giants as Fujitsu, Hitachi and Toshiba announced massive cuts in employment as their profits collapsed. These were matched by countless smaller lay-offs at less well-known Japanese firms.

Banking blues

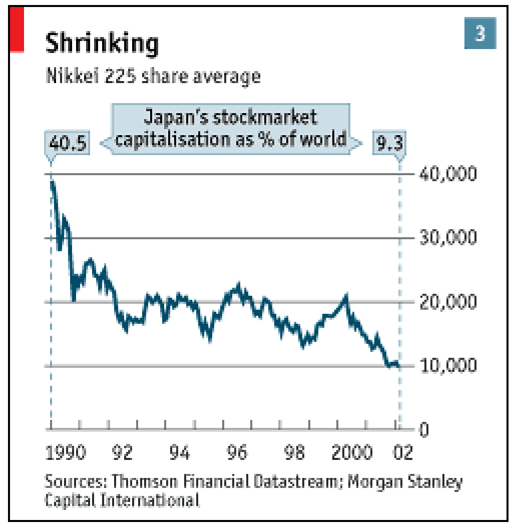
This deflationary trend is one reason why informed observers now feel so jittery. A second reason stems from Japan's rickety banking system (a natural consequence of all those indebted companies), and from the common knowledge that the government must one day accept that it will have to do more to deal with the burden of banks' bad loans. Although this has been obvious for years, a confluence of coming events has persuaded many investors that the day of reckoning is near.

On April 1st, Japan will start a new financial year, which this time round will set off a pair of decisive changes. Banks, which own lots of Japanese equities, will be made to value these shares at market prices. Because equity prices have fallen sharply since the shares were bought, the banks will have to show losses of more than one-and-a-quarter times their operating profits. Although those losses have already occurred, admitting to them could cause fresh problems if it prompts more depositors or investors to flee.

Depositors are anyway nervous, because of another change due on April 1st. After putting it off last year, the government will finally begin rolling back the blanket deposit insurance that it introduced in 1998. The first stage will affect only time deposits, and will limit insurance to ¥10m ($75,200) per depositor at each bank in which the person or institution holds an account. Many depositors have already moved their money, spreading it around in ¥10m instalments and transferring much of the rest into other types of deposits, which will remain insured for another year. The risk remains that the partial repeal will cause bank runs. Some Japanese have been buying gold for safety.

These looming changes, by raising the odds that Japan's long-awaited crisis will at last arrive, leading to some kind of economic meltdown that could be cathartic but might be disastrous, have helped to send asset prices tumbling. Share prices have fallen yet again, to their lowest levels since the mid-1980s. The Nikkei 225 stockmarket average, which in its proudest moment in 1989 approached 40,000, now languishes at around 10,000 (see chart 3).

Worse will follow if bond investors come to share the alarm. So far they have been subdued, keeping the government's debt-service payments in check. But, after running up fiscal deficits throughout the past decade's slump, Japan's official public debt has risen to 130% of GDP. Even the fuzziest maths cannot disguise that the real problem is much worse. For a start, Japan's deflation is causing nominal GDP to shrink, driving up the debt-to-GDP ratio even without any new spending. Add to that a continuing annual deficit, to avoid adding fiscal contraction to the economy's other woes, and the debt ratio will go on rising. The budget that Mr Koizumi wants to pass, which is modest by his ruling party's standards, will easily drive the ratio above 140% within a year.

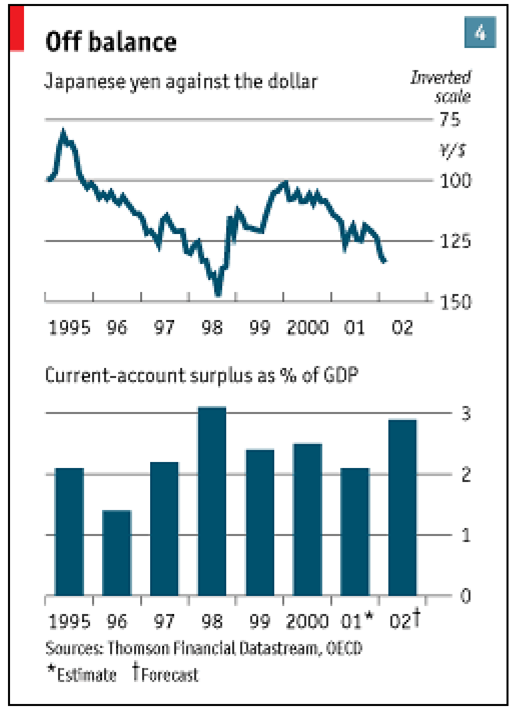


None of this includes the cost of the government's other liabilities, stemming from publicly-backed corporations, social-security promises, and, if it is forced to nationalise the banks, the cost of cleaning up their balance sheets. Japan's fiscal position is, in short, pretty dreadful. This has already prompted downgrades by the rating agencies: this week, Moody's said it might lower Japan's credit rating to the same levels as Poland and South Africa. The only blessing is that foreigners hold little of the government's debt, which may still allow it to postpone a bond-market panic.

Thus both the pace of economic deflation and the risk of financial implosion seem to have gone up a notch or two lately. But neither of these threats is new. And, even if the risks are now higher, Japan might still find a way to muddle through and delay any real crunch—as it has managed to do for most of the past ten years.

Even those onlookers who still downplay the situation are fretting, however, for a third reason. Unlike most previous bouts of panic over Japan, they fear, this one has far more potential to cause trouble in the rest of the world. With much of East Asia still in recession, and an American recovery still shaky and uncertain, an implosion of what is still the world's second-biggest economy could seriously damage the global economy. Japan remains a big trader, investor and lender, so any collapse would affect all its counterparties. And even if Japan pursues mild efforts to avoid it, its trading partners, especially in the rest of Asia, will still share its pain.

The most visible sign of this risk is the yen, which began sliding towards the end of last year. It has recently settled down, hovering around 133 to the dollar (see chart 4). But even that has prompted outcries from Japan's East Asian neighbours, as well as from the United States. America's big car makers petitioned Mr Bush, apparently with little success, to put their troubles with Japanese rivals on the agenda of his meeting with Mr Koizumi. Last month America's treasury secretary, Paul O'Neill, also delivered a mild rebuke while he was in Tokyo, by urging Japan not to drive its currency down at the expense of other "reforms".



Reform, reflate or both

Mr O'Neill thus plunged headlong into a contentious and confused debate that has plagued Japan for years: reflate first and reform later? Or vice versa? Or just reflate? A simple dispute over this is hardly the crux of the problem. Vested interests—among the bureaucracy, the politicians of the ruling Liberal Democratic Party (LDP) and the disproportionately powerful voting blocks that back it—are clearly the prime culprits. These groups benefit in some ways from Japan's malaise, especially from the fiscal gravy train that has rattled along unhindered throughout the slump. Just as important, these factions are perennially battling each other, over which of them should bear the shame and financial costs of fixing the problem.

Japan's vested interests do not merely frustrate reform through unpopular votes in the Diet, Japan's parliament. They also command much of the machinery through which ideas are evaluated and turned into legislation. If a prime minister wants to challenge them, he has little chance of even bringing a good alternative up for a vote. That makes it harder for the Japanese voters to vet recovery plans clearly, and make their wishes known. When combined with backroom dealing, lacklustre mass media and the cacophony of factional battles, this had made it all but impossible for any plan to achieve a consensus. And, when there is no consensus, Japan tends to revert to autopilot.

Politically, therefore, Japan would find it hard to recover even if disinterested experts could agree on what it should do. Yet, even without worrying about who wins and loses, economic analysts continue to bicker among themselves over the answer. All agree, however, on Japan's need to inflate its way out of trouble. Its private and public debts are enormous. Falling prices make almost everything worse. Any effort to tackle Japan's numerous other problems will require much more borrowing or take another big chunk out of domestic demand. There is no realistic way forward, therefore, without steps to get Japanese prices rising, preferably by several percentage points a year. This would not only boost nominal demand, but would lower the public and private debt burden in real, inflation-adjusted, terms.

Unfortunately, a collapsed asset bubble followed by years of inaction have made it hard for Japan to achieve inflation, since expectations of flat or falling prices are so entrenched. With short-term interest rates at zero, the Bank of Japan has tried to loosen things further through "quantitative easing", making more funds available to banks. But that has done little to boost broad-money supply; bank lending has been falling inexorably for four years.

Technocrats debate ways to fix this problem. One approach is to get the banks to finance Japan's fiscal deficit directly, bypassing the bond markets. Another is to print yen and use them to buy up foreign bonds. But most economists agree that, if Japan is to achieve inflation, the yen will have to fall much further, perhaps to between 180 and 200 to the dollar.

What about structural reform? Should it wait for inflation or be done in parallel? Various groups are juggling different reform plans to fix Japan's "structural problems" and help restore growth. There is certainly a risk that harsh supply-side reforms would, on their own, make things worse, rather as they did in American in the 1930s; Japan's chief problem is shortage of demand, even though some demand may be suppressed by supply-side problems. So the most sensible option is to work in parallel with inflation, to the extent that Japan can achieve it. The prime candidates for reform are Japan's insolvent banks, along with their mirror reflections, overly indebted companies.

Along with slumping demand, Japan is now beset by overcapacity in many industries, such as construction and retailing. Many of these companies can never be profitable, but because the banks continue to prop them up they can avoid going bust. As they continue to cling on, meanwhile, the walking dead drive down prices and capture business from healthier rivals.

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Looked at in isolation, this competition seems good for consumers, since everybody must cut prices. But when you step back and look more carefully, say structural-reform advocates, far from promoting "market competition" in Japan, the corporate zombies are perpetuating the deflationary spiral. Take over the banks and let these companies go bust, say the reformers, and you will help arrest deflation by eliminating much excess capacity.

It does not matter so much exactly how the government does this. It could nationalise the banks, and use its control to deny credit to hopeless debtors. Or it could single out the most indebted companies and find some way to drive them into receivership, perhaps by simply publishing a list and letting suppliers and lenders do the job. Either way, the effect would be the same. It would also be helpful to cut off the fiscal tap to sectors such as construction, and perhaps channel more public money towards the workers who will be laid off after structural reforms.

Koizumi's conundrum

How has all this affected Mr Koizumi's calls for reform? The basic, abridged, version is that Mr Koizumi, a longstanding LDP insider with a funky hairstyle and a gift for plain talk, persuaded the party's grass roots that he was more eager for change than his rivals in the LDP leadership, and that this was a good thing. The party rank-and-file propelled him to the top last April, after the previous prime minister, Yoshiro Mori, bumbled himself out of the job.

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Mr Koizumi started off well, promising to clean up the banks, restrain government borrowing and derail the gravy train through "structural reform without sanctuary". The wider public adored his brisk style of speaking, and his promises to inflict pain for the sake of future gain. When teamed up with his combative foreign minister, Makiko Tanaka, who promised to expose corruption and insubordination in her ministry, Mr Koizumi achieved strong public approval, with more than 80% of Japanese voters, at the high points, saying that they backed his government.

Koizumi looks into the abyss

But three developments have helped to pull Mr Koizumi to earth. First, he could not reform much since he does not really run Japan. The despised "resistance forces" in the LDP and the bureaucracy have watered down all his plans and slowed their passage, depriving Mr Koizumi of both momentum and results.

Second, these forces, having bought time, have cashed in on the recession by persuading people that Japan needs to pursue "anti-deflation" (by which the LDP means more public spending) before structural reforms (which would cut off the tap). This put pressure on Mr Koizumi to push his own budget, which at least has better priorities than his opponents'.

But then he botched his response to the third development: Ms Tanaka's battle with the bureaucrats and the LDP old guard. In order to ease the passage of his budget, Mr Koizumi sacrificed Ms Tanaka, foolishly provoking a backlash and losing his only real asset, his popularity.

What happens now? Many of Mr Koizumi's reforms seem less likely than ever to happen. If asset prices continue to slide, the government may have to deal more actively with the banks' bad debts. More likely, it will keep muddling through, announcing just a few measures to prop up the banks, without solving their underlying problems. A mildly lower yen might, in the meantime, mildly boost exports; and Japan may get a boost in May and June when it co-hosts soccer's World Cup. Alas for Mr Koizumi, and for Japan, the real crisis that would force an acceptance of reforms could still take longer to arrive.